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84-165

No. ______

In The

Supreme Court of the United States

October Term 1984

W. GEORGE GOULD,

Petitioner,

vs.

MAX A. RUEFENACHT, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED

Is the purchaser of 50% of the stock of a closely-held corporation, who obtains absolute veto power over all major corporate decisions, intends to share all top level business decisions, and actively participates in the company's affairs, entitled to federal securities law protection simply because the transaction was structured as a stock purchase?

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioner respectfully prays that a writ of certiorari issue to review the order and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on June 11, 1984.

OPINIONS BELOW

The opinion of the Court of Appeals, entered June 11, 1984, is not yet officially reported; it is unofficially reported at [Current Binder] Fed. Sec. L. Rep. (CCH) ¶91,514, at 98,592 (3d Cir. June 11, 1984). A copy of that opinion is annexed as Appendix A. The unreported opinion and related orders of the United States District Court for the District of New Jersey are annexed as Appendix B.

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on June 11, 1984. Jurisdiction to review that judgment by writ of certiorari exists pursuant to 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are those sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 that define the term "security." The definition contained in the Securities Act of 1933, 15 U.S.C. 77b(1), is as follows:

> When used in this subchapter, *unless the context otherwise requires*—
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privi-

> lege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. 77b(1) (1982) (emphasis added).

The definition of "security" contained in the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), is, for present purposes, essentially identical. In each instance, the definition is preceded by the phrase "unless the context otherwise requires." The Securities Act of 1933 and the Securities Exchange Act of 1934 will hereafter be referred to collectively as the "securities laws."

Other statutory provisions involved herein are sections 12 and 17 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934, including Securities and Exchange Commission Rule 10b-5 promulgated thereunder. These provisions are reproduced at Appendices C through F.

STATEMENT OF THE CASE

A. Circumstances of the Transaction

In June, 1980 plaintiff-respondent Max A. Ruefenacht ("Ruefenacht") purchased 2500 newly-issued shares of the common stock of Continental Import and Export, Inc. ("Continental"), an importer and distributer of wines and spirits. As a result of the purchase, Ruefenacht owned 50% of the company's outstanding shares.

The agreed-upon purchase price was $250,000, a sum which reflected a "discount" to Ruefenacht in return for his agreement to actively participate in Continental's business. In addition, in connection with the stock purchase Ruefenacht acquired multifaceted control over the company's affairs, and in fact actively participated therein, to wit: (1) he acquired the right to veto all major company decisions, both structural and operational, including stock issuance, liquidation, obtaining new product lines and borrowing funds; (2) he was to become chairman of the board of directors; (3) he was extensively involved in numerous regular meetings with suppliers, and solicited contracts to import beverages on behalf of the firm; (4) he actively participated in the company's sales and marketing efforts, in connection with which he applied for and received a state liquor license (or solicitor's permit), representing therein that he would sell alcoholic beverages to wholesalers and receive in return a salary and compensation for expenses; (5) he became a signatory for Continental's checks, and to do so denominated himself as the company's vice-president and treasurer; (6) he substantially influenced or directed the hiring of key personnel; and (7) he issued directions to Continental's counsel regarding securing wine label approvals. Ruefenacht paid $120,000 of the

total $250,000 purchase price for Continental's stock, and shortly thereafter abruptly withdrew from the company.

B. The Proceedings Below

Ruefenacht then commenced this action, alleging that his purchase of Continental stock was induced by fraudulent and negligent misrepresentations contained in certain financial documents prepared by Christopher O'Halloran (the company's accountant), and made orally by defendants Joachim Birkle (Continental's president, who owned or controlled the remaining 50% of Continental's stock), and petitioner W. George Gould (Continental's corporate counsel). Violations are alleged of sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. 77 1(2), 77q(a) (1982); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78 j(b) (1982); and Rule 10(b)(5), 17 C.F.R. 240.10(b)(5) (1983). Also alleged are pendent state claims for fraud and breach of fiduciary duties. The complaint seeks rescission and restitution of the amount paid.

Defendant-petitioner Gould moved for summary judgment dismissing the complaint on the ground that limited discovery showed Ruefenacht to have acquired such significant control over Continental's business, and to have participated in the company's affairs to such a degree, that his stock purchase was not an idle investment with profits to come solely or primarily from the efforts of others. Therefore, Ruefenacht could not claim protection under the federal securities laws, pursuant to the authority of *S.E.C. v. W.J.Howey Co.*, 328 U.S. 293 (1946) (hereinafter "*Howey*"); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (hereinater "*Forman*"); and *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (hereinafter "*Weaver*").

The trial court held an evidentiary hearing[1] on the issue of the extent of control over Continental acquired by Ruefenacht in connection with the stock purchase. A number of specific factual findings (summarized under section A above) were made, providing the basis for the ultimate factual conclusions that Ruefenacht *was* "an active investor who intended to participate significantly in the management of the business," and *not* "a passive investor who relied on others to manage the business." As a result of Ruefenacht's control of and participation in Continental's affairs, the trial court held that "the profits of the enterprise would not be derived 'solely' or substantially from the efforts of others," and, therefore, under the authority of *Howey*, *Forman* and *Weaver*, dismissed all federal securities law claims. Additionally, the court in its discretion dismissed all pendent state law causes of action.

On Ruefenacht's appeal, the Third Circuit held that no economic analysis of the transaction should have been made, and that the securities laws apply to the transaction *a fortiori* because stock with "traditional" attributes was involved. Accordingly, the judgment dismissing Ruefenacht's complaint was reversed and the matter remanded.

Gould filed a motion to stay the mandate, pursuant to Fed. R. App. P. 41(b). By order dated July 6, 1984, issuance of the mandate was stayed until August 1, 1984.

1. The matter was referred to the magistrate who, after receiving testimonial and documentary evidence, rendered a report and recommendations.

REASONS FOR GRANTING THE WRIT

I. Granting This Petition Will Permit The Court To Delimit The Definition Of "Security" Under Federal Law, In Conjunction With *Seagrave Corp. v. Vista Resources, Inc.*

By granting certiorari in *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982), *modified*, 710 F.2d 95 (1983), *cert. granted*, 52 U.S.L.W. 3185 (1984) (hereinafter "*Seagrave*"), this Court acknowledged the need to resolve the split in Circuit Court authority regarding the important issue of when a transfer of stock is not a transaction in "securities" within the meaning of the Securities Act of 1933 and Securities Exchange Act of 1934.[2] The issue in *Seagrave* is whether

2. The issue has been considered by nine courts of appeal, which are divided five to four. The Second, Fourth, Fifth and Eighth Circuits, and now the Third Circuit, reject application of the "economic reality test" applied in *Howey*, *Forman* and *Weaver*, where stock having "traditional" attributes is transferred. *See* App. A; *Daily v. Morgan*, 701 F.2d 496, 497-504 (5th Cir. 1983); *Cole v. PPG Indus., Inc.*, 680 F.2d 549, 555-56 (8th Cir. 1982); *Golden v. Garafolo*, 678 F.2d 1139, 1140-47 (2d Cir. 1982); *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). These courts hold that where "traditional" stock is involved in a transaction, the securities laws apply *a fortiori*, whether or not the protective purposes of those laws are implicated.

The Seventh, Ninth, Tenth and Eleventh Circuits hold that the economic realities of *each* transaction, including those involving a transfer of "traditional" stock, must be examined to determine whether application of the securities laws is consistent with the intended ambit and supporting policies of the statutes. *Landreth Timber Co. v. Landreth*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,705, at 97,827 (9th Cir. March 7, 1984), *petition for cert. filed*, 52 U.S.L.W. 3908 (U.S. May 31, 1984) (No 83-1961); *Christy v. Cambron*, 710 F.2d 669, 672 (10th Cir. 1983); *Sutter v. Groen*, 687 F.2d 197, 199-204 (7th Cir. 1982); *King v. Winkler*, 673 F.2d 342,344-46 (11th Cir. 1982).

the federal securities laws apply to a transfer of 100% of the "traditional" stock of a closely-held corporation. The matter thus is representative of a number of cases upholding or rejecting application of the securities laws in the context of a transfer of *total* corporate ownership, and hence *complete* corporate control. *See, e.g.*, (upholding application of the securities laws to a 100% stock transfer): *Occidental Life Ins. Co. v. Pat Ryan Assocs., Inc.*, 496 F.2d 1255, 1261-63 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Spencer Cos., Inc. v. Armonk Indus., Inc.*, 489 F.2d 704, 707 (1st Cir. 1973); *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 615 (7th Cir. 1973), *rev'd on other grounds sub nom, Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974); *Walling v. Beverly Enters.*, 476 F.2d 393, 395 (9th Cir. 1973). *See contra* (rejecting application of the securities laws to a 100% stock transfer): *Chandler v. Kew, Inc.*, 691 F.2d 443, 443-44 (10th Cir. 1977); *Frederiksen v. Poloway*, 637 F.2d 1147, 1150-54 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); *Somogyi v. Butler*, 518 F. Supp. 970, 981-87 (D.N.J. 1981); *Anchor-Darling Indus., Inc. v. Suozzo*, 510 F. Supp. 659, 662-66 (E.D. Pa. 1981).

The instant case adds two important factual dimensions not present in *Seagrave*. Should this Court conclude that the economic realty test is the applicable standard, analysis of these additional factors will permit a definitive delineation of the manner of application of that test, so as to ameliorate the uncertainties and resultant tide of litigation which persist in this area.

Ruefenacht's Purchase of 50% of Continental's Stock

First, this case involves a 50% stock transfer (as opposed to the 100% transfer in *Seagrave*), which the trial court found vested in Ruefenacht joint control (with one other shareholder) of the company such that he was able to veto all major corporate decisions.

This factor is important because decisions on *both sides* of the debate as to when stock is not a "security" for purposes of federal law regard a transfer of 50% stock ownership as a critical theoretical dividing line in evaluating whether, or in what manner, a transfer of corporate control affects securities law coverage. For example, the Seventh Circuit in *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982), applying the economic reality test to a stock transfer, established 50% stock ownership as the point beyond which one presumptively becomes an "entrepreneur" disqualified from securities law coverage, as opposed to an "investor" entitled to federal law protection. *Id.* at 203. Other courts have been greatly influenced by this approach—as noted by the Third Circuit herein, "[t]he Ninth, Tenth and Eleventh Circuits have followed the Seventh Circuit's lead." App. A at 5a.

Conversely, the Third Circuit in the present matter found great conceptual difficulty applying the economic reality test to a 50% stock purchase situation, citing such difficulty as one basis for rejecting that test in its entirety as applied to traditional stock:

> The case now before us illustrates just how far the extension of *Howey* from investment contract to note to stock may be taken. Ruefenacht is the purchaser of 50 percent of the stock of Continental. Had he purchased only 49 percent, Ruefenacht would presumably have lacked corporate control, rendering the instrument purchased (at least presumptively) a security. Had he purchased 51 percent, in contrast, the instrument would presumptively not have been a security. Both presumptions, of course—at least under the Seventh Circuit ap-

proach, *see Sutter*, 687 F.2d at 203—would have been subject to rebuttal. Because Ruefenacht purchased exactly 50 percent, a more sophisticated analysis would presumably be required—although just what that analysis should be is less than obvious.

App. A at 15a.

The Third Circuit's view—that uncertainty of application of the economic reality analysis (as exemplified by the difficult 50% transfer situation) shows the test to be inherently flawed—is shared by other courts. *See, e.g., Golden v. Garafolo, supra; Daily v. Morgan, supra.*

Granting certiorari in the present case will allow the Court to address fundamental conceptual issues regarding the importance *vel non* of a transfer of corporate control in resolving questions of securities law coverage, both in the context of a transfer of total corporate control (as in *Seagrave*) and in the context of a transfer of control which is less than total, but still undeniably significant.[3]

Expansion of the issue to encompass a situation of less than a complete transfer of control is necessary to provide needed guidance in this important field. Any holding in *Seagrave* involving application of the economic reality test necessarily will be restricted to situations involving a 100% stock transfer, and thus will leave unresolved application of the economic analysis to a wide range of circumstances involving a transfer of less than total control. Such a result will largely fail to ame-

3. This Court's conclusion in *Weaver* that a "measure of control," 455 U.S. at 560, was an important factor in disqualifying a transaction from securities law coverage obviously has not settled the issue, nor provided clear practical criterion.

liorate the business uncertainties and flood of litigation regarding the scope of federal securities law coverage which, presumably, the grant of certiorari in *Seagrave* sought to address. In order to provide needed practical guidelines concerning the manner and extent to which a transfer of corporate control disqualifies a transaction from securities law coverage, it is necessary to address the present 50% transfer situation which, while more analytically challenging, provides the conceptual framework for putting to rest many fundamental uncertainties and concerns in this area of law.

Ruefenacht's Active Participation In Continental's Business

The second important factual element of this case is the trial court's specific findings (after an evidentiary hearing) that Ruefenacht *was* "an active investor who intended to participate significantly in the management of the business," and was *not* a "passive investor who relied on others to manage the business." App. B at 48a-49a.

Granting certiorari here thus will allow the Court to examine a second fundamental question regarding application of the economic reality test, namely: What are the nature and limits of permissible activity in a business which is consistent with a claim of protection under the federal securities laws? In issue is the meaning and scope of that essential aspect of the test which requires a "security" transaction to involve "an investment in a common venture premised upon a reasonable expectation of profits *to be derived from the entrepreneurial or managerial efforts of others.*" *Forman*, 421 U.S. at 852 (emphasis added). The parameters of this aspect of the test also are a matter of uncertainty. *See, e.g., Forman*, 421 U.S. at 852, n.16; *Lino v. City Investing Co.*, 487 F.2d

689, 692 (3d Cir. 1973); *S.E.C. v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

No exposition of this aspect of the economic reality test is permitted by the facts of *Seagrave*, where the plaintiff/purchaser apparently was entirely "passive" and did not actually participate in the acquired company's business. However, the specific factual findings in this case, regarding Ruefenacht's active involvement in Continental's affairs, enable the Court to set needed parameters and practical guidelines, and thereby promote the certainty of application which is so acutely needed in this area.

II. The Writ Should Be Granted To Resolve The Conflict In Circuit Court Authority Regarding Issues Of Great Importance In Application Of The Securities Laws.

The conflict among the Circuit Courts of Appeal, which this Court acknowledged by granting certiorari in *Seagrave*, has been exacerbated by the Third Circuit's ruling here, and by the recent ruling of the Ninth Circuit in *Landreth Timber Co. v. Landreth*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,705, at 97,824 (9th Cir. March 7, 1984).[4]

These decisions present a split in Circuit Court authority which could not be more evenly divided. The Second, Third, Fourth, Fifth and Eighth Circuits[5] embrace a literal and reflexive application of the securities laws where "traditional" stock is involved in a transaction. These courts eschew any distinctions based upon the protective purposes of those laws, but instead cite the difficulty of drawing such distinctions as a reason for rejecting any case-by-case analysis. The inexorable result is that legions of commercial transactions which in no way implicate the protective purposes of the securities laws are subjected to those enactments. This authority, in short, exalts the form of a transaction over its economic substance, and thereby expands federal securities law coverage far beyond its intended scope.

In contrast, the Seventh, Ninth, Tenth and Eleventh Circuits[6] utilize a case-by-case analysis of a transaction's economic substance to determine whether the protective purposes of the securities laws are implicated, and whether a claimant for such protection belongs to that class of persons which Congress intended to afford federal relief. In this analysis, such courts consider the extent to which such a claimant has relinquished control of his investment, so as to be dependent upon the managerial or entrepreneural efforts of others for a return of profit—a situation whose abuse was the primary impetus for enactment of the securities laws. By such an approach these courts do *not* restrict coverage of the securities laws, but rather *conform* coverage to the intended ambit of the statutes.

The manifest result of this division is a patchwork of judicial authority whereby, paradoxically, national securities laws coverage is in many cases determined by the geographical locus of the parties or transaction.

The need for intervention by this Court is clear and compelling. The authority cited above, reflecting the debate as to the scope of the definition of "security,"

4. A petition for a writ of certiorari was filed on May 31, 1984 and is pending. *Landreth Timber Co. v. Landreth*, No. 83-1961.

5. *See supra* note 2.

6. *See supra* note 2.

shows only the tip of the iceberg of confusion which remains after the rulings in *Forman* and *Weaver.* Surely myriad unreported matters in district courts throughout the country have been diverted from the enforcement of substantive rights in order to choose sides in the debate. Moreover, and perhaps of greater importance, undoubtedly such pervasive confusion has adversely affected untold numbers of business transactions, the parties to which must guess as to the reach of the securities laws, and even as to the criterion by which the scope of those laws will be defined.

III. The Third Circuit's Ruling Conflicts With The Holdings of *Forman* and *Weaver*

Forman made clear that, while the economic reality test was first articulated in a case involving an investment contract, it in fact is "the basic principle that has guided all of [this] Court's decisions" applying the securities laws to particular transactions. *Forman*, 421 U.S. at 848.

Repeatedly in *Forman* this Court emphasized that application of the securities laws depends upon the substance or economic reality of a transaction, rather than the literal form of the instrument utilized, to wit:

> Because securities transactions are economic in character Congress intended the application of these statutes to turn on the *economic realities underlying a transaction*, and not on the name appended thereto.

421 U.S. at 849 (emphasis added).

***

> We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security.' " In either case, the basic test for distinguishing the transaction from other commercial dealings is
>
> > "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301.
>
> This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a *security*. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

421 U.S. at 852 (footnote omitted) (emphasis added).

***

> What distinguishes a *security transaction*—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others . . . .

421 U.S. at 858 (emphasis added).

These pronouncements clearly are concerned not simply with the definitions of "stock" and "investment contract," but rather with the definition of "security." *Forman* thus holds that in all cases application of the federal securities laws depends upon an economic analysis of each transaction, to the end of determining whether the claimant for federal relief is a member of the class of persons which those laws were intended to protect.

The Third Circuit erroneously rejected *Forman's* teachings, fundamentally on the rationale that *Forman* intended to distinguish between "traditional" and "non-traditional" securities. The source of this error is the Third Circuit's misinterpretation of *Forman's* reference to the "traditional" characteristics of stock. In the course of rejecting the literalist view that the name given an instrument is controlling of securities law coverage, this Court stated:

> In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

421 U.S. at 850-51.

Forman went on to conclude that there could be no such justifiable assumption by the lessees there, because the "stock" in issue had none of the characteristics "that in our commercial world fall within the ordinary concept of a security." *Id.* at 851, citing H.R. Rep. No. 85, 73d Cong., 1st Sess. 11(1933).

The above-quoted passage and the immediately following discussion in *Forman* led the Third Circuit, and has led other Circuits, to the erroneous conclusion that *Forman* intended to distinguish between "traditional" and "non-traditional" securities. Petitioner believes that such error has resulted from overreading and taking the above quote out of context, combined with misdirected zeal to uphold the "remedial" purposes of the securities laws.

These cases ignore the plain fact that *Forman's* reference to "traditional" stock or its characteristics was in the context of discussing a possible reliance claim, where a purchaser reasonably assumes the securities laws to apply. *Forman* left open the possibility that circumstances could exist where a justifiable expectation that the securities laws will apply to a transaction may create grounds for their application. Put another way, *Forman* stated that where a purchaser of "securities" not otherwise covered by federal law is "misled," 421 U.S. at 851, into believing that the federal securities laws apply, such a belief may justify invoking the protection of those laws. By the above quote and following discussion, *Forman* simply stated that such a claim is strengthened where "traditional" securities are involved, because it is more likely that such an expectation would be created in that circumstance.

The Third Circuit also failed to follow *Weaver*, which, in rejecting securities law coverage, applied an economic analysis to the two instruments there involved: a "traditional" certificate of deposit, and a private agreement between the parties. With respect to the issue of *when* the economic substance of a transaction must be examined, the Court stated explicitly and unmistakably that:

> *Each transaction* must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

455 U.S. at 560 n.11 (emphasis added).

Weaver thus reaffirms the ruling in *Forman* that the name affixed to an instrument does not control whether it is a "security"; rather, the economic realities of *each transaction* must be examined to determine securities law coverage.

CONCLUSION

This petition presents an opportunity for the Court to bring substantial certainty and predictability to the scope of the federal securities laws, an area which has suffered in confusion for nearly ten years since *Forman*. For this reason, and those discussed above, a writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit.

Respectfully submitted,
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DATED: July 26, 1984

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 83-5493

MAX A. RUEFENACHT

v.

CHRISTOPHER J. O'HALLORAN,
JOACHIM K. BIRKLE and
CONTINENTAL IMPORT & EXPORT, INC., and
W. GEORGE GOULD

CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,

v.

W. GEORGE GOULD, ESQ.,
Third-Party Defendant,

W. GEORGE GOULD,
Third-Party Plaintiff,

v.

DAVID BERNSTEIN,
AUTOBERN TRADING CO., INC.,
ERNEST STOECKLIN,
LENZENHOF GMBH
Third-Party Defendant,

MAX A. RUEFENACHT,
Appellant.

ON APPEAL FROM THE UNITED STATES
DISTRICT COURT FOR THE
DISTRICT OF NEW JERSEY
D.C. Civil No. 80-4097

ARGUED: May 14, 1984

BEFORE: GIBBONS and HUNTER, *Circuit Judges*, and RAMBO, *District Judge**

(Opinion Filed: June 11, 1984)

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OPINION OF THE COURT
(Filed June 11, 1984)

GIBBONS, *Circuit Judge.*

This appeal requires that we determine whether stock transferred to effectuate the sale of all or part of a business is a "security" within the meaning of the 1933 and 1934 Securities Acts.[1] The district court, holding that the purchase or sale of 50 percent of the stock of a business is a security only if the transaction satisfies the "investment contract" or "economic reality" test of *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), entered summary judgment for the defendants. The plaintiff, and the Securities and Exchange Commission as *amicus curiae*, urge that

1. Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1982); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982).

the district court erred in applying the *Howey* test in these circumstances. The question whether the *Howey* test applies to the sale of stock having the traditional attributes of stock ownership is the subject of considerable academic commentary[2] and has produced a split of authority in the circuits.[3] Joining the Second, Fourth,

2. *See, e.g.*, Easley, *Recent Developments in the Sale-of-Business Doctrine: Toward a Transactional Context-Based Analysis for Federal Securities Jurisdiction*, 39 Bus. Law. 929 (1984) [hereafter Easley, *Recent Developments in the Sale-of-Business Doctrine*]; Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Security Transaction*, 57 N.Y.U. L. Rev. 225 (1982); Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine under the Federal Securities Laws*, 37 Bus. Law. 637 (1982); Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. Ill. L. Rev. 413; FitzGibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 Minn. L. Rev. 893 (1980); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 Hastings L.J. 219 (1974); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 Okla. L. Rev. 135 (1971); Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 Case W. Res. L. Rev. 367 (1967); Note, *Repudiating the Sale-of-Business Doctrine*, 83 Colum. L. Rev. 1718 (1983) [hereafter Note, *Sale-of-Business Doctrine*]; Comment, *A Criticism of the Sale of Business Doctrine*, 71 Calif. L. Rev. 974 (1983); Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 Fla. St. U.L. Rev. 295 (1980).

3. The Second, Fourth, Fifth, and Eighth Circuits have rejected the sale-of-business doctrine. *see* Daily v. Morgan, 701 F.2d 496, 497-504 (5th Cir. 1983); Cole v. PPG Indus., Inc., 680 F.2d 549, 555-56 (8th Cir. 1982); Golden v. Garafalo, 678 F.2d 1139, 1140-47 (2d Cir. 1982); Coffin v. Polishing Machs., Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

The Seventh Circuit has taken the lead in applying the doctrine to the purchase of all or part of the stock of a business. *See* Sutter v. Groen, 687 F.2d 197, 199-204 (7th Cir. 1982); Canfield v. Rapp & Son, Inc., 654 F.2d 459, 463-66 (7th Cir. 1981); Frederiksen v. Poloway, 637 F.2d 1147, 1150-54 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). The Ninth, Tenth, and Eleventh Circuits have followed the Seventh Circuit's lead. *See* Landreth Timber Co. v. Landreth, [1984] Fed. Sec. L. Rep. (CCH) ¶ 99,705 (9th Cir. 1984); Christy v. Cambron, 710 F.2d 669, 672 (10th Cir. 1983); Kaye v. Pawnee Constr. Co., 680 F.2d 1360, 1366 n.2 (11th Cir. 1982); King v. Winkler, 673 F.2d 342, 344-46 (11th Cir. 1982). *See also* Chandler v. KEW, Inc., 691 F.2d 443, 443-44 (10th Cir. 1977).

On one occasion this court applied the federal securities laws to the sale of 50 percent of the common stock of a close corporation without expressly addressing the applicability of the sale-of-business doctrine. Glick v. Campagna, 613 F.2d 31, 35 (3d Cir. 1979). *See also* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 270-73 (3d Cir. 1978) (sale of controlling stock interest in corporate subsidiary constitutes sale of securities).

On the morning of oral argument in this case, the Supreme Court granted certiorari in a Second Circuit case rejecting the sale-of-business doctrine. *See* Seagrave Corp. v. Vista Resources, Inc., 710 F.2d 95 (2d Cir. 1983) (per curiam) (following *Golden v. Garafalo, supra*), *cert. granted*, 52 U.S.L.W. 3827 (U.S. May 14, 1984) (No. 83-1084).

Fifth and Eighth Circuits, we hold that the *Howey* test does not apply to the sale of all or part of a business effectuated by the transfer of stock bearing the traditional incidents of stock ownership. Thus we reverse.

I. Facts and Proceedings in the District Court

Continental Import & Export, Inc., is an importer of wines and spirits. Joachim Birkle is president of Continental and, until 1980, owned or controlled 100 percent of its stock. Ruefenacht, the plaintiff, alleges that early in 1980 he purchased 2500 shares of Continental's stock for $250,000—said to represent 50 percent of the company—in reliance on financial documents and other oral representations made by Birkle, Christopher O'Halloran, a certified public accountant, and W. George Gould, Continental's corporate counsel.

In deposition testimony, Ruefenacht asserted that the consideration for the price paid for Continental's stock

included a promise be him to devote certain efforts to the firm's business. In conformance with that promise, Ruefenacht engaged in various activities on behalf of company. In the summer of 1980, for example, he solicited contracts to import beverages on behalf of the firm. On other occasions Ruefenacht participated in the hiring of company employees. He also applied for and received a state liquor license (or solicitor's permit), representing at that time that he would sell alcoholic beverages to wholesalers and receive in return a salary and compensation for expenses. On another occasion Ruefenacht signed a banking resolution denominating himself an officer of Continental. That resolution was signed at Birkle's request for the purpose of permitting Ruefenacht to sign corporate checks when Birkle was out of the country.

The record also reveals that Ruefenacht participated in the affairs of Continental in other minor ways He attended luncheon meetings, occasionally translated documents, maintained telephone contact with Continental employees on a regular basis, and visited warehouses considered for use by Continental. While engaging in these activities, however, Ruefenacht remained a full-time employee of another corporation. Moreover, his actions on behalf of Continental were at all times subject to the veto of Birkle.

After Ruefenacht paid $120,000 of the total $250,000 purchase price for Continental stock, he began to doubt the accuracy of certain representations made to him by Birkle and others. Soon thereafter he filed this action, alleging violations of sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77l(2), 77q (1982), section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), and Rule 10(b)(5), 17 C.F.R. § 240.10(b)(5) (1983). Ruefenacht charges that financial statements prepared by O'Halloran and signed by Birkle

overvalued Continental's goodwill and licenses by $243,000; that these financial statements assigned a $400,000 value to import or contract rights with no substantial worth; that the firm reported a surplus when in actuality it maintained a deficit; and that the defendants represented that net profits on sales between 1980 and 1981 would be $848,000 under a nationwide distribution program, and $1.197 million in the New York area, when in fact Continental was not seriously negotiating contracts for nationwide distribution at all and could not reasonably project these net earnings. In reliance on these representations, Ruefenacht alleges, he had purchased 1000 shares of Continental's stock and had advanced $120,000 to Birkle. The Complaint seeks rescission and restoration of the amount paid. Ruefenacht also pleads pendent state claims for fraud and breach of fiduciary duties.[4]

The district court granted summary judgment for defendants, concluding that the stock purchased by Ruefenacht was not a "security" within the meaning of the 1933 and 1934 Acts. The court so concluded not because the instrument purchased by Ruefenacht lacked any of the indicia of stock ownership; indeed, the court conceded that the "stock which Ruefenacht received contains all the attributes mentioned by the *Forman*[5] Court as indicating that the transaction did involve a security." App. at 220. Rather, the court held, the instrument was not a "security" because of the degree of Ruefenacht's control over Continental's business. "Because Mr. R[ue]fenacht intended to jointly manage Continental

4. Gould has impleaded Autobern Trading Corp., Ruefenacht's full-time employer. Bernstein and Stoecklin, associates of Birkle and Ruefenacht, and Lenzenhof GmbH, a German Corporation controlled by Birkle, Birkle and Continental have defaulted.

5. United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975).

with Mr. Birkle," the district court reasoned, "he did not purchase 'securities' as defined in the federal acts." App. at 309. Finding no federal jurisdiction over the securities claims, the district court dismissed the complaint in its entirety.

II. History of the Sale-of-Business Doctrine

The 1933 and 1934 Securities Acts include within the definition of "security" a series of specific terms—*e.g.*, "note," "stock," "bond," and "debenture"—and thereafter employ a number of more general phrases—*e.g.*, "investment contract," "any interest or instrument commonly known as a 'security.' "[6] As early as 1943 the Supreme Court held that certain novel economic transactions were encompassed within these latter, more generic terms, even though not embraced by their more specific provisions like "stock," "bond," or "note." *See SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 348-55 (1943) (holding that leasehold interests in property adjacent to exploratory oil wells were "securities"). The Court's leading opinion on this point, *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), held that agreements for the sale of a citrus crop coupled with optional service contracts were "investment contracts." *Howey* propounded a definition of "investment contract" derived from descriptions widely employed in state "blue sky" laws: an investment contract, the Court held, is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ." *Id.* at 298-99. This definition came to be known as the "*Howey* test" and led many courts to classify a variety of novel economic schemes as "investment contracts."[7]

6. 15 U.S.C. §§ 77b(1), 78c(a)(10) (1982). These definitions are subject to many important qualifications: the definitions and their qualifications are examined in greater detail in Part III A *infra*.

While the court were giving the term "investment contract" a broad compass, the more specific term "note" was read narrowly, so as not to embrace every instrument comporting with the Acts' terms that is technically a "note" under state law. The first appellate holding that not every such "note" is a "security" under the federal Acts is this court's decision in *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973).[8] In *Lino*, this court held that a personal promissory note tendered as partial consideration for rights under a franchise agreement was not a "note" under the federal Acts. *Id.* at 693-96. Significantly, we did not apply the *Howey* test to the notes in question, as Part I of the opinion pointedly made clear by applying the *Howey* test to the franchise agreements themselves. *Id.* at 691-93. Rather, we examined the entire context of the note transactions, declining at that time to expound "a 'test' . . . that would aid in determining whether there has been a purchase or sale of securities when a personal promissory note is involved." *Id.* at 696 n.15.

Following *Lino's* lead, several courts strove to define the circumstances under which a "note" should be considered a "security" under the Securities Acts. The Fifth

7. *E.g.*, Smith v. Gross, 604 F.2d 639, 642-43 (9th Cir. 1979) (per curiam) (earthworms); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414, 416-18 (8th Cir. 1974) (chinchillas); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-85 (5th Cir. 1974) (cosmetics); SEC v. Glenn W. Turner Enters., 474 F.2d 476, 480-83 (9th Cir.) (self-improvement courses), *cert. denied*, 414 U.S. 821 (1973).

8. *See* Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1134 (2d Cir. 1976) (Friendly, J.) (acknowledging *Lino* as first appellate holding to narrow the breadth of "note" under the federal Acts).

Circuit sought to determine whether a note comprised an "investment."[9] The Ninth Circuit approached the problem on a slightly different tack, seeking to determine whether the lender supplies "risk capital" to the maker.[10] In a leading opinion written by Judge Friendly, the Second Circuit rejected both of these approaches. *See Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) (Friendly, J.). In part the Second Circuit feared that the "investment" and "risk capital" tests obliterated Congress' carefully drawn distinctions among those notes included within and excluded from the Acts. Congress took care to provide that any note arising out of a "current transaction" and having a maturity not exceeding nine months was excluded from the registration provisions, but included in the antifraud provisions, of the 1933 Act;[11] and that any note with a maturity not exceeding nine months was excluded from the 1934 Act.[12] As the Fifth Circuit candidly acknowledged, its "investment test" "virtually writes [these

9. In a discussion not entirely free of self-defining terms, the Fifth Circuit characterized a "note" under the federal Acts as either (1) "offered to some class of investors," (2) "acquired for speculation or investment," or (3) exchanged to "obtain investment assets, directly or indirectly." McClure v. First Nat'l Bank of Lubbock, 497 F.2d 490, 493-94 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *see also* Bellah v. First National Bank of Hereford, 495 F.2d 1109, 1111-13 (5th Cir. 1974) (adopting distinction between "investment" and "commercial" loan).

10. Great Western Bank & Trust Co. v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976). Six factors bore on the Ninth Circuit's analysis: (1) "time," (2) "collateralization," (3) "form of the obligation," (4) "circumstances of issuance," (5) relationship between the amount borrowed and the size of the borrower's business," and (6) "contemplated use of the proceeds." *Id.* at 1257-58 (emphasis omitted).

11. 15 U.S.C. §§ 77c(a)(3), 77q(c) (1982).

12. 15 U.S.C. § 78c(a)(10) (1982). *See* Part III A *infra*.

distinctions] out of the law." *McClure v. First National Bank of Lubbock*, 497 F.2d 490, 494 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). In addition, the Second Circuit expressed concern over the uncertainty that would inevitably follow from a weighing of factors "without any instructions as to [their] relative weights." *Exchange National Bank*, 544 F.2d at 1137. In lieu of the "investment" and "risk capital" approaches, the Second Circuit enumerated a family of note transactions presumptively excluded from the Act—all concerning consumer financing or business financing of current costs—and held that other notes not bearing the family pedigree were presumptively securities under federal law.[13]

There matters stood when late in 1976 the Seventh Circuit held that the *Howey* test for "investment contract" applies to determine whether a "note" is a security under the Acts. *Emisco Industries, Inc. v. Pro's Inc.*, 543 F.2d 38, 39-40 (7th Cir. 1976). The extension of *Howey*

13. Judge Friendly wrote:

> One can readily think of many cases where [the context requires that a note is not within the Act]—the note dlivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized). When a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply.

544 F.2d at 1138 (footnote omitted). Recently the Second Circuit added a new member to this family: notes evidencing loans by commercial banks for current operations. *See* Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 939 (2d Cir. 1984) (Friendly, J.).

into the note arena was problematical. This application of *Howey* further obliterated the special statutory distinctions drawn by Congress among notes included in and excluded from the Acts, and injected into the note area the same uncertainty that pervades litigation over the inherently vague term "investment contract." Moreover, the Seventh Circuit doctrine seemed to ignore some important statutory policies underlying the securities Acts. As the legislative history makes abundantly clear,[14] one such policy is the protection of "investors"; and to the extent that *Howey* maps the entire set of "investors" marked for protection—not an obviously correct assumption—then that policy may be satisfied. But a second policy of the Acts is, as we observe below, the protection of the marketability of certain instruments of commerce, whether or not purchased by "investors" under the *Howey* formula. Among the favored instruments, for example, is certain commercial paper.[15] Several com-

14. *See* note 33 *infra*.

15. The SEC regards commercial paper as exempt from the *registration* provisions of the 1933 Act, *see* 15 U.S.C. § 77c(a)(3) (1982), only if the paper is:

> prime quality negotiable paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve Banks.

Securities Act Release No. 4412, 26 Fed. Reg. 9158, 9159 (1961); *see* 17 C.F.R. § 231.4412 (1983). Commercial paper is not exempt from the *antifraud* provisions of the 1933 Act. *See* 15 U.S.C. § 77q(c) (1982); Part III A *infra*.

Most courts have applied the criteria of Release 4412 to the 1934 Act exemption as well. *E.g.*, Mallinckrodt Chem. Works v. Goldman, Sachs & Co., 420 F. Supp. 231, 240 (S.D.N.Y. 1976); Alton Box Board Co. v. Goldman, Sachs & Co., 418 F. Supp 1149, 1157 (E.D. Mo. 1976) (citing *Levy infra*), *rev'd on other grounds*, 560

mentators have perceptively remarked that an application of the "investment" or "*Howey*" tests to these commercial instruments would undermine federal protection for many instruments most deserving of coverage.[16]

Notwithstanding these concerns, in 1981 the Seventh Circuit extended the *Howey* or "economic reality" test to the purchase or sale of *stock*. *Frederikson v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). While the extension of the *Howey* test to the note area had ben greeted with some concern, the further extension of that doctrine to the purchase or sale of stock sparked a considerable amount of alarm.[17] While the difficulties attending the simple extension of *Howey* to notes still applied, two other difficulties loomed even larger.

First, at least in the note area there is, as we held in *Lino*, some necessity for fine-tuning the definition of "note" to avoid sweeping within the coverage of section

F.2d 916 (8th Cir. 1977); Franklin Savings Bank v. Levy, 406 F. Supp. 40, 43-44 (S.D.N.Y. 1975), *rev'd on other grounds*, 551 F.2d 521, 527-29 (2d Cir. 1977); Welch Foods v. Goldman, Sachs & Co., 398 F. Supp. 1393, 1397-98 (S.D.N.Y. 1974). *See generally* Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 Bus. Law. 1567, 1574 & nn. 27-28, 1586-87 & n.86 (1980); Note, *The Commercial Paper Market and the Securities Acts*, 39 U. Chi. L. Rev. 362, 380-401 (1972) [hereafter Note *Commercial Paper*].

16. *See* Sonnenschein, *supra* note 15, 35 Bus. Law. at 1595 & n.131; Coffey, *supra* note 2, 18 Case W. Res. L. Rev. at 381-403; Hannan & Thomas, *supra* note 2, 25 Hastings L.J. at 219-53.

17. *E.g.*, Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983); Cole v. PPG Indus., Inc., 680 F.2d 549 (8th Cir. 1982); Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982); Coffin v. Polishing Machs., Inc., 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 8868 (1979). For incisive academic commentary, see Note, *Sale-of-Business Doctrine*, *supra* note 2, 83 Colum. L. Rev. 1718 (1983); Comment, *A Criticism of the Sale of Business Doctrine*, 71 Calif. L. Rev. 974 (1983).

10(b) of the 1934 Act every consumer and business loan financing current operational costs. But there is no such necessity in the stock area. Stock is a well-defined term, is not issued by consumers, and is not ordinarily employed by business to finance current transactions. While the importation of the *Howey* test into the note arena might be justified as an expedient—albeit an imperfect one—for limiting the definition of "note," no such expedient seems necessary for the issue of stock.

Second, because the *Howey* test turns in part on whether the purchaser derives profits "from the entrepreneurial or managerial efforts of others," *see United Housing Foundation, Inc. v. Forman*, 421 U.S. 834, 852 (1975), a central aspect of the test, when applied to stock, requires a determination whether the purchaser exercises a controlling share of the corporation.[18] A controlling share may be exercised with less than 100 percent stock ownership—indeed, at times with far less than 50 percent ownership. *See Sutter v. Groen*, 687 F.2d 197, 203 (7th Cir. 1982). Thus an instrument might be transformed from a security into a non-security by virtue of a small increase in the number of shares traded. Instruments purchased by multiple investors might be securities as to some purchasers and non-securities as to others, or securities as to sellers but not as to purchasers.[19] Instruments might be securities if traded in a series of small transactions but non-securities if the same transaction is effectuated in a single sale. To many judges and lawyers with up to 50 years of experience with the securities laws, these seemed extraordinary consequences.[20]

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18. *See, e.g.*, Thompson, *supra* note 2, 57 N.Y.U. L. Rev. at 253-61, Seldin, *supra* note 2, 37 Bus. Law. at 661-62.

19. *See* McGrath v. Zenith Radio Corp., 651 F.2d 458, 467-68 n.5 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981).

20. Until recently, courts expressed little doubt that the sale of 100 percent of the stock of a business (and *a fortiori* less than 100

The case now before us illustrates just how far the extension of *Howey* from investment contract to note to stock may be taken. Ruefenacht is the purchaser of 50 percent of the stock of Continental. Had he purchased only 49 percent, Ruefenacht would presumably have lacked corporate control, rendering the instrument purchased (at least presumptively) a security. Had he purchased 51 percent, in contrast, the instrument would presumptively not have been a security. Both presumptions, of course—at least under the Seventh Circuit approach, *see Sutter*, 687 F.2d at 203—would have been subject to rebuttal. Because Ruefenacht purchased exactly 50 percent, a more sophisticated analysis would presumably be required—although just what that analysis should be is less than obvious.

III. The Securities Acts as Interpreted by the Supreme Court

If Congress or the Supreme Court has mandated these results, then, regardless of their deficiencies in logic, we

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percent) constituted the sale of a "security" under the Acts. *See* Occidental Life Ins. Co. v. Pat Ryan Assocs., Inc., 496 F.2d 1255, 1261-63 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); Spencer Cos. v. Armonk Indus., Inc., 489 F.2d 704, 707 (1st Cir. 1973) (denying preliminary injunction but assuming stock was a security); Alberto-Culver Co. v. Scherk, 484 F.2d 611, 615 (7th Cir. 1973), *rev'd on other grounds sub nom.* Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974); Walling v Beverly Enters., 476 F.2d 393, 395 (9th Cir. 1973) (exchange of all common stock).

The parties appear to have assumed that the sale of 100 percent of the stock of a firm constitutes the sale of a "security" in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). There ther Supreme Court doubted whether a non-purchaser/non-seller (Manhattan Casualty Co.) had standing to invoke the Acts, *see id.* at 13-14 n.10, a question later settled in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). No party at any stage of the litigation, however, appears to have questioned that the stock constituted a "security."

would be bound to apply them. We turn, therefore, to the language, history, structure, and policies of the 1933 and 1934 Acts. Then we consider the impact of recent Supreme Court Decisions.

A. *Statutory Language, Structure, and History*

1. *The definition and exemption provisions*

Section 2(1) of the 1933 Act as amended provides that the term "security"

> means any note, stock, treasury stock, bond, debenture, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a "security". . . .

15 U.S.C. § 77b(a) (1982). The legislative history to section 2(1) indicates that Congress cast the definition of security "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933).

Although Congress intended that the term "security" embrace those instruments that "fall within the ordinary concept of a security," several important qualifications limit this definition. Preceding all of the definitions in the 1933 Act is the clause "unless the context otherwise requires." The significance of the so-called "context clause" is addressed in Part III A 3 *infra*.

In addition, section 3 of the 1933 Act defines a number of important "exempted securities." Among the defined exemptions in the 1933 Act is an exception for short-term notes. Section 3(a) provides that the Act shall not apply to:

> Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction

> . . . and which has a maturity at the time of issuance of not exceeding nine months . . . .

15 U.S.C. § 77c(a)(3) (1982). As one commentator has observed. Congress intended the short-term note exemption to free from the Act's registration requirements prime quality commercial paper sold to knowledgeable investors. The necessity for disclosure in a registration statement to these investors was less vital than for sales of other, more speculative paper to other, less knowledgeable buyers.[21] Congress did not, however, include the "commercial paper" exception in the antifraud provisions of the 1933 Act. *See* 15 U.S.C. § 77q(c) (1982).

The 1933 Act also empowers the Commission to grant additional exemptions. Section 3(b) of the Act as amended provides that:

> The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000 [then $100,000].

15 U.S.C. § 77c(b) (1982). Congress envisioned that the Commission's exemption power would be reserved for "needless registration of issues of such an insignificant

21. *See* Note, *Commercial Paper*, *supra* note 15, 39 U. Chi. L. Rev. at 384. Accordingly, the Commission requires that, in order to qualify for the section 3 exemption to registration, short-term commercial paper be of prime quality and of a kind not marketed to the general public. *See* note 15 *supra*.

character as not to call for regulation." H.R. Rep. No. 85, *supra*, at 15. According to the House Report, however, the Commission's exemption power was carefully limited by the prohibition on exemptions for issues larger than $100,000 (now $5,000,000), "thus safeguard[ing] against any untoward pressure to exempt issues whose distribution may carry all the unfortunate consequences that the act is designed to prevent." *Id.*

The definition of "security" under the 1934 Act parallels that under the 1933 Act. Section 3(a)(10) of the 1934 Act provides that " 'security' means any note, stock, treasury stock, bond, debenture, . . . investment contract, . . . or in general, any instrument commonly known as a 'security.' " 15 U.S.C. § 78c(a)(10) (1982).[22] One important distinction between the 1933 and 1934 Act definitions pertains to short-term notes: generally speaking, short-term notes that would be exempt from the registration provisions of the 1933 Act are exempted from the antifraud provisions of the 1934 Act.[23] And like the 1933 Act, section 3(a)(12) of the 1934 Act authorizes the SEC to grant additional exemptions for classes of securities either unconditionally or upon specialized terms and conditions.[24] 15 U.S.C. § 78c(a)(12) (1982).

22. A Senate Report describes these definitions as "substantially the same." S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934). *See* United Housing Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975); Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967).

23. The subtle distinctions in short-term note coverage under the Acts is examined in Note, *Commercial Paper*, *supra* note 15, 39 U. Chi. L. Rev. at 380-401; and in *Exchange National Bank*, *supra*, 544 F.2d at 1131-32. *See* note 15 *supra*.

24. Section 3(a)(12) as amended provides:

> The term "exempted security" or "exempted securities" included . . . such other securities . . . as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this chapter which by their terms do not apply to an "exempted security" or to "exempted securities".

15 U.S.C. § 78c(a)(12) (1982).

Nowhere in these provisions is there an exemption for the sale of a controlling share of corporate stock. This conspicuous omission is significant for two reasons. First, Congress took pains to exempt certain commercial paper from the class of "notes" covered by the registration provisions of the 1933 Act and the antifraud provisions of the 1934 Act. When Congress wished to exempt a class of instruments from some or all of the Acts' provisions, it had little trouble in doing so expressly.[25] And while it might be argued that purchasers of large blocks of stock, often in face-to-face transactions, are more knowledgeable than the average investor—and therefore often less in need of protection—the same argument applies to the commercial paper exception. Congress exempted certain commercial paper in part because it is high-grade and purchased by knowledgeable investors; accordingly, the SEC approves for exemption only that commercial that is "prime quality" and "of a type not ordinarily purchased by the general public." *See* note 15 *supra*. These arguments persuaded Congress to exempt prime quality commercial paper expressly. Congress did not, however, exempt particular stock transactions. Moreover, while Congress may not have considered the sale of all or part of a business by means of a stock purchase under the 1933 Act—the Act is, of course, primarily addressed to "public offerings," *see* 15 U.S.C. § 77d(2) (1982) (private offering exemption), and the sale of a business is fre-

25. *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733-34 (1975) (noting distinction between "*purchase* or sale" in § 10(b) of 1934 Act and "*offer* or sale" in § 17(a) of 1933 Act, and stating, "When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly."); *see also* Touche Ross & Co. v. Redington, 442 U.S. 560, 572 (1979); Southeastern Community College v. Davis, 442 U.S. 397, 411 (1979).

quently not effectuated by a "public offering"—the same cannot be said of the 1934 Act. It was always clear that the 1934 Act would, by its terms, apply to stock purchases comprising controlling corporate shares. Nor can it be said that Congress did not envisage face-to-face transactions; it has always been clear that the Act applies to face-to-face sales of stock as well as to transactions in the recognized markets. *See Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982); *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 10, 12 (1971) ("Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face").[26]

Second, Congress vested in the SEC the responsibility for identifying certain securities for exemption. In addition, Congress empowered the SEC to attach conditions to any exemptions granted in order to protect the investing public. These decisions suggest that in the judgment of Congress the Commission, and not the courts, has the expertise and practical experience required to ensure that exemptions to the Act are prudently chosen, and that appropriate conditions are attached to any exemptions granted. Needless to say, the SEC has never exempted the purchase or sale of a controlling share of corporate stock from the definition of security. Thus we look on the plea that this court do so with some skepticism.

2. *Text of the definitions and early interpretations*

The definition of "security" under both Acts begins with an enumeration of specific terms—"note," "stock," "bond," "debenture"—and then proceeds to more general phrases, including "investment contract." This procession from the specific to the general did not escape the Supreme Court's attention on its first occasion to consider the definition of "security." In *SEC v. C.M. Joiner Corp.*, 320 U.S. 344 (1943), the Court observed:

> In the Securities Act the term "security" was defined to include by name or description many documents in which there is common trading for speculation or investment. Some, such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well-settled meaning. Others are of more variable character and were necessarily designated by more descriptive terms, such as "transferable share," "investment contract," and "in general any interest or instrument commonly known as a security." *We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents.* Instruments may be included within any of these definitions, as a matter of law, if on their face they answer to the name or description. However, the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as [a] matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character as "investment contracts," or as "any interest or instrument commonly known as a 'security.' "

320 U.S. at 351 (emphasis added). Thus, the Supreme Court recognized that instruments like "stock," "bonds," and "notes" answer "on their face . . . to the name or description." The Acts' latter phrases, intended to supplement these common instruments, were devised to capture "[n]ovel, uncommon, or irregular devices" that were not so readily classified. This construction is consistent with the fact that the terms "stock," "bond," and "note" had well-defined meanings under state corporate

26. *See also* Daily v. Morgan, 701 F.2d 496, 502 (5th Cir. 1983); Golden v. Garafalo, 678 F.2d 1139, 1146-47 (2d Cir. 1982).

law that Congress obviously had incorporated by reference, and that Congress did not intend the reach of the Act to stop with these well-defined terms alone.

The Court's next bout with the definition of security confirmed that the phrase " 'investment contract" also drew on state law for its content. In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court held that in the words "investment contract" Congress had employed a term "common in many state 'blue sky' laws." *Id.* at 298. Despite Justice Frankfurter's position in dissent that the phrase " 'investment contract' is not a term of art," *id.* at 301 (Frankfurter, J., dissenting), the Court held that by "including an investment contract within the scope of [the Act], Congress was using a term the meaning of which had been crystallized by [state] judicial interpretation[s]." *Id.* at 298. These state definitions, the Court held, "had been broadly construed by state courts so as to afford the investing public a full measure of protection." *Id.*

Thus, by 1946 it was plain that the definitions in the 1933 and 1934 Act drew on state law for their content, and that in order to embrace novel or unusual investment schemes within the salutary provisions of the Acts, Congress supplemented standard state-law definitions of "stock," "note," etc., with more general phrases, including "investment contract," drawn from state law. *Joiner* and *Howey* make plain that Congress did not intend to *circumscribe* the scope of the standard terms—"stock," "note," "debenture"—to that of the more generous phrases. To the contrary, that construction would turn the history of the Acts and the state-law definitions on their heads. Congress never intended that "stock" that did not also satisfy the definition of "investment contract" would not be within the Acts' terms. Rather, Congress intended that "investment contracts" that did not

also satisfy the definition of "stock" *would be* within the Acts' terms. See *Tcherepnin v. Knight*, 389 U.S. 332, 342 (1967) (*Joiner* "rejected the respondents' invitation to 'constrict the more general terms substantially to the specific terms which they follow' ").

The language of the definition itself makes this consideration clear. As the Second Circuit recently noted, there would have been little reason for the drafters to have employed words like "stock," "bond," and "note"—which had clear definitions under state law—if their intention had been to include only those instruments that satisfied an economic reality" test appropriate to the latter terms. If an economic reality test appropriate to these subsequent terms were intended, "a substantial portion of each class of instrument would, in fact, not be within the definition." *Golden v. Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982).

To be sure the *Howey* Court also admonished that "[f]orm was [to be] disregarded for substance" and that "emphasis was [to be] placed upon economic reality." 328 U.S. at 298. Those words were written, however, in the context of disregarding the absence of a label like "stock" or "note" when novel schemes nonetheless constitute "investments" earnings profits from the labor of others. They did not direct us to ignore the presence of an instrument that, as a matter of economic reality, is "stock" simply because it is not purchased by one who also entered into an "investment contract."

In summary, neither the language, the history, the structure, nor the Acts' early interpretations suggest that the transfer of stock to effectuate the sale of all or part of a business is not the purchase or sale of a "security." And several considerations—particularly Congress' express treatment of notes and its conferral on the SEC of the power to specify exempt securities—suggest the contrary.

We now consider the impact of the "context clauses" on our analysis.

3. *The "context clauses"*

Each of the definitional sections of the 1933 and 1934 Acts begins with the wprds, "When used in this [sub]-chapter, unless the context otherwise requires—." 15 U.S.C. §§ 77b, 78c(a) (1982). These clauses, the defendants maintain, authorize us to narrow the definition of "stock" as the "economic realities" require. In considering this position, we turn to the history and function of the clauses.

Perhaps the most notable feature about the "context clauses" is that they do not appear in the paragraphs defining "security" at all. Instead, these clauses precede all fifteen definitions in the 1933 Act and all forty definitions in the 1934 Act. Plainly, the "context clauses" were not directed particularly at the definition of "security." This lack of particular application is underscored by the legislative history of the definitions of "security." In neither the House nor the Senate reports, for example, did the drafter allude to the clauses or indicate that particular kinds of stock, notes, or debentures are embraced by the Act "only when the context requires." If the drafters had indeed intended that the context clause exempted certain named securities from coverage, they certainly made no mention of it.

The legislative evolution of the 1933 Act suggests even more strongly that the context clauses had no such purport. Section 2 of the Senate version of the 1933 Act provided, "When used in this Act the following terms shall, *unless the text otherwise indicates*, include the following respective meanings." H.R. 5480, 73d Cong., 1st Sess. 39 (1933) (emphasis added) (as enacted by the Senate on May 10, 1933); S. 875, 73d Cong., 1st Sess. 1 (1933). This Senate bill tracked the language of an early

House bill, H.R. 4314, which had also opened with the phrase "unless the text otherwise indicates." H.R. 4314, 73 Cong., 1st Sess. 2 (1933). Early in the legislative process, however, the House Committee on Interstate and Foreign Commerce substituted the language "unless the context otherwise requires" for the phrase "unless the text otherwise indicates. *See* H.R. 5480, 73d Cong. 1st Sess. 1 (1933) (as enacted by the House on May 5, 1933). Ultimately the Conference Committee adopted the House version. Although the Conference Committee Report dicusses a number of significant distinctions between the House and Senate definitions, the Report makes no mention of the difference between these prefatory clauses. *See* H. Conf. Rep. No. 152, 73d Cong., 1st Sess. 24-25 (1933).

It seems evident that the drafters did not attribute particular significance to the distinction between these House and Senate phrases. The "text" to which the Senate had adverted was obviously the text of the statute itself. Similarly, the "context" to which the House referred was obviously the context in which the defined words appear in the statute itself. Both the House and Senate provisions were intended to direct that the ensuing definitions were to be used throughout the statute unless the text of the Act expressly, or another section of the statute implicitly, made them inapplicable to that section.[27]

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27. The commentators are in general agreement with this interpretation. *See* Sonnenschein, *supra* note 15, 35 Bus. Law. at 1577-78 & n.44; Hannan & Thomas, *supra* note 2, 25 Hastings L.J. at 277-79; 2 L. Loss, Securities Regulation 1698, 1705 (2d ed. 1961); 4 L. Loss, Securities Regulation 2485 (2d ed. Supp. 1969). The Commission also has interpreted the "context clauses" to refer to the context in which the defined terms appear in the Acts. *See* 1 L. Loss, Securities Regulation 215, 524-25, 533, 642-43 (2d ed. 1961); 2 *id.* at 1696 n.33. Moreover, the Supreme Court too has interpreted the clause in this fashion. *See* SEC v. National Securities, Inc., 393 U.S. 453 (1969):

The defendants, however, would have us attribute a very different meaning to the "context" language. That language, they assert, refers not only to the statutory context but to the context of the *underlying factual transaction*.[28] Thus, they argue, the House and Senate versions of the 1933 Act had very different meanings. The Senate version, of course, would not have admitted of the defendants' interpretation, for it would have authorized exceptions as "the text otherwise indicates," not as the factual circumstances seem to warrant. The House version, in contrast, as the defendants construe it, sanctioned a wide-ranging exemption power varying with the facts and circumstances. It strikes us that if the conferees had observed so considerable a distinction between the House and Senate bills and had selected the broader, House version, they would at least have remarked upon so important a subject. Moreover, a wide-ranging exemption power is inconsistent with the Act's conferral of exemption power on the SEC. Because the Act conferred a narrowly tailored exemption power on the Commission, it seems extraordinary that the conferees should not have remarked upon a decision to confer a potentially broader power through the context clause.

These considerations lead us to conclude that the context clauses themselves do not authorize judicial exclusions of securities from the scope of the Act when the "factual circumstances" seem to warrant it. Of course, we do not thereby adopt a wooden approach to statutory construction. The Supreme Court has often admonished that a "thing may be within the letter of the statute and yet not within the statute." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975) (quoting *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892)). We simply observe that Congress did not intend the context clause as a font of authority to narrow the compass of the term "stock" when the underlying facts may seem to warrant. If that result is to obtain, it must devolve from some other indication in the language, structure, or legislative history of the Acts. The context clause alone is no such authority.[29] As Judge Friendly has written, "[s]o long as the statutes remain as they have been for over forty years, courts had better not depart from their words without strong support for the conviction that, under the authority vested in them by the 'context' clause, they are doing what Congress wanted when they refuse to do what it said." *Exchange National Bank*, 544 F.2d at 1138.

> Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase "unless the context otherwise requires."

Id. at 466. *See also* note 29 *infra*.

28. The Seventh Circuit has espoused this "factual context" position. *See* Emisco Inds., Inc. v. Pro's Inc., 543 F.2d 38, 39 (7th Cir. 1976); C.N.S. Enters., Inc. v. G & G Enters., Inc., 508 F.2d 1354. 1357-62 (7th Cir.). *cert. denied*, 423 U.S. 825 (1975).

IV.

A. *Policy Considerations*

As additional guides to Congress' intent, we examine the reasons and policies that gave rise to protection of securities under the 1933 and 1934 Acts.

29. *See, e.g.*, Marine Bank v. Weaver, 455 U.S. 551 (1982), holding that a certificate of deposit was not a security under the federal securities Acts because it enjoyed sufficient protection under the banking laws. *Id.* at 558-59. Alhough the Court relied in part on the context clause, its holding was independently supported by the legislative history and structure of the banking laws and securities Acts.

1. *Uncertainty of application*

The most prominent feature of the sale-of-business doctrine is its attendant uncertainty of application, and for that reason we address this feature first. We agree with the Seventh Circuit that corporate control may be exercised with less than 100 percent of the outstanding stock of a firm, and therefore that if the sale-of-business doctrine is to be applied, it must logically be extended to all such purchases and sales. *Sutter v. Groen*, 687 F.2d 197, 203 (7th Cir. 1982). No doubt, for example, the doctrine must be applicable with equal rigor to the purchase of 15 percent of a firm's stock as to the purchase of all 100 percent. This conclusion raises the specter of examining, in every securities transaction, the niceties of corporate control. Such an examination would be no small task. Control may be exercised, for example, by alliances of minority shareholder factions. One indicator of whether a minority share effectively exercises control might be whether the purchase price of the share exceeded the prevailing market price. Another might be the voting patterns of various factions. Yet another might be the extent of management involvement by the faction, including, for example, whether various management employees were appointed by or are allied with that faction. And of course, testimony might be taken on the intent of the purchasers and the realities of corporate management. Even a purchaser who acquires more than 51 percent of the stock may not control with respect to certain corporate modifications for which the certificate of incorporation or state law may require supermajorities. *E.g.*, 8 Del. Code Ann § 102(b)(4) (1983). One commentator urges that even a buyer of 100 percent of the stock of a firm should be accorded the protections of the Acts "[i]f this party can prove he intended to be, and thereafter remained, a passive investor." Easley, *Recent Developments in the Sale-of-Business Doctrine*, *supra* note 2, 39 Bus. Law. at 971-72. Wholly apart from the

oddity of making what a security *is* depend upon these factors, they raise the prospect of a substantial hearing in many cases simply to determine whether an instrument is a "security."

The Seventh Circuit acknowledges the uncertainty that would flow from this investigation, but discounts it. To interpret the Acts as creating private rights of action in favor of "entrepreneurs," the Seventh Circuit has reasoned, "is to go awfully far for the sake of having to make some distinctions." *Sutter*, 687 F.2d at 202. We are not as placid about this prospect as is the Seventh Circuit. After all, the costs of legal rules accrue not only to the courts but to those members of the public who must structure their affairs accordingly. Counsel must be hired to predict whether the purchase of a large block of stock will render it a security or a non-security. Doubts will be created over whether registrations are necessary. All of this uncertainty has real economic costs. It is one thing, if the sale-of-business doctrine were capable of clear application, to say "caveat emptor" and let the market price reflect that the purchaser no longer has federal protection from fraudulent representations. But it is another thing if the buyer and seller are unable to predict readily whether their instruments are "securities" at all. That uncertainty raises the cost of economic transactions, inhibits the flow of capital, spawns litigation, and in general benefits neither the parties nor the courts.[30]

2. *Marketability of instruments and necessity for protection*

A concern related to the uncertainty of application is the marketability of certain favored instruments. The

30. *See* Daily v. Morgan, 701 F.2d at 503; Golden v. Garafalo, 678 F.2d at 1145-46; Note, *Sale-of-Business Doctrine*, *supra* note 2, 83 Colum L. Rev. at 1741-44.

Acts apply not only to the sale of stock on the nationally recognized markets, but to the sale of "notes," "bonds," "debentures," and other instruments sold in non-market transactions. *See Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982). Certain commercial paper, for example, is illustrative. *See* note 15 *supra*. In favoring these widely recognized instruments, Congress reduced the transaction costs associated with their transfer; buyers may rely on the accuracy of representations made without instituting expensive investigations into information over which the seller has knowledge and control, and without demanding a premium price to reflect the risk of fraudulent representation This protection facilitates the ready sale of instruments in interstate commerce.

The sale of a business by means of stock is such a transaction. As the Fifth Circuit has observed,

> there are special risks involved in the sale of stock in a corporation that might justify special protection. Generally speaking, one who purchases the assets of a business is not liable for its debts and liabilities, while one who purchases the stock in a corporation—a separate legal entity—assumes ownership of a business with both assets and liabilities. . . . Liabilities, alas, are often the subject of inaccurate or incomplete disclosures.

Daily v. Morgan, 701 F.2d 496, 504 (5th Cir. 1983).[31] Of course, the buyer can reduce these risks by employing

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31. *See also* Exchange National Bank, 544 F.2d at 1137 ("While banks are in a favored position to obtain disclosure, the target of [the Acts] is fraud, which a bank's ability to obtain disclosure cannot always prevent."); Occidental Life Ins. Co. v. Pat Ryan & Assocs, Inc., 496 F.2d 1255, 1263 (4th Cir.) ("In one sense the large investor has a more pressing need for protection to the extent that he has expended a greater amount of his resources."), *cert. denied*, 419 U.S. 1023 (1974); Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334, 336 (W.D. Pa. 1980); Titsch Printing, Inc. v. Hastings, 456 F. Supp. 445, 449 (D. Colo. 1978).

professionals to comb through the most intricate details of the seller's business. But such an investigation is costly and inefficient: the seller controls this information and is already in possession of it; and the buyer's investigation is time-consuming and expensive, thereby raising transaction costs and inhibiting the flow of capital. One of Congress' purposes in singling out the named instruments in the Act was to facilitate such transactions without the ensuing delays, duplication of effort, and expenses associated with the "caveat-stockholder" era of deregulation. *See* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 4-5 (1934). Denial of the Acts' protection in these circumstances would undermine this Congressional policy.[32]

3. *Justifiable expectations and value of the bargain*

A third concern related to the foregoing considerations is the protection of the value of the bargain to the buyer. One of the advantages to the buyer of employing stock to effectuate the sale of a business is the buyer's justifiable reliance on the antifraud provisions of the Acts to reduce transaction costs. Accordingly, the buyer may pay a price for the business that does not reflect a premium for the cost of ensuring the accuracy of all representations made. The Supreme Court has observed that such reliance by the buyer would be reasonable when the stock purchased has the traditional attributes commonly associated with stock ownership. In *United Housing Founda-*

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32. Thus, we are unpersuaded by the argument that a sophisticated buyer with substantial resources is in a position to detect fraud and therefore undeserving of coverage. This argument misses the point. Of course the buyer may hire accountants and attorneys to scrutinize the seller's business; however, it is more efficient for the seller to warrant the accuracy of representations made than for the buyer to expend substantial amounts of time and money unearthing facts already known to the seller. This efficiency is one of the purposes of the Acts and promotes the marketability of securities and free flow of capital.

tion, Inc. v. Forman, 421 U.S. 837 (1975), the Court reasoned:

> There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

Id. at 850-51. In the case of stock, the Court held, those characteristics include the right to receive dividends contingent upon an apportionment of profits; negotiability; capacity for use as collateral; voting rights in proportion to the number of shares owned; and share appreciation. *Id.* at 851.

The district court concluded that the stock purchased by Ruefenacht bears these characteristics, and we accept that conclusion for the purposes of this appeal. Consequently, Ruefenacht would have been justified in agreeing on a purchase price that did not include a premium reflecting the risk of fraud. This savings to Ruefenacht represented part of the value of the bargain: and to withhold the Acts' protection in these circumstances would be to deprive the purchaser of that part of the value of the bargain.

4. *Protection of "investors"*

Congress unquestionably intended that the Act protect "investors" in the national securities markets.[33] It would, however, be a grave mistake to conclude that this single purpose exhausted Congress' intent. As we have observed, Congress acted with a number of rationales in mind, among them the facilitation of commerce in certain named instruments to reduce transaction costs and enhance the free flow of capital. Thus, we disagree with the Seventh Circuit's view that the function of the federal Acts is limited solely to the protection of "investors," however defined. *Sutter*, 687 F.2d at 201. But even insofar as the Acts address "investors," there are flaws in the sale-of-business doctrine. The distinction between an "entrepreneur" and an "investor" is hardly obvious. Many investors may elect to participate in the management of a business in order to enhance their return on investment; indeed, in our free-enterprise system that is to be expected. Just why investors who choose to engage in entrepreneurship in order to improve the performances of their investment cease to be "investors," and become instead exclusively "entrepreneurs," is something of a mystery. It seems clear to us that these persons are both investors and entrepreneurs.[34] Even were Congress exclusively concerned with "investors" and not "entrepreneurs"—an assumption with which we strongly disagree—Ruefenacht is certainly an "investor."

Moreover, nothing suggests to us that the *Howey* test for investment accurately maps the universe of investors with which Congress might have been concerned. The *Howey* test emerged from the definition of "investment contract" under state "blue sky" laws. As used by state

33. For a review of some of the legislative history referring to the protection of investors in the national markets, *see Daily v. Morgan*, 701 F.2d at 500-02 n.5; *Sutter v. Groen*, 687 F.2d at 201.

34. *See* Daily v. Morgan, 701 F.2d at 503; Golden v. Garafalo, 678 F.2d at 1146 ("in truth, purchasers of a business rightly regard themselves as investors as well as managers"); Note, *Sale-of-Business Doctrine*, *supra* note 2, 83 Colum L. Rev. at 1738-39.

The Seventh Circuit acknowledges that purchasers may be both investors and entrepreneurs but assumes that investment must constitute the "purchaser's *main purpose*." *Sutter*, 687 F.2d at 203 (emphasis added). We see no evident source in the Acts for the requirement that investment must be a "main purpose" rather than a

courts and the Supreme Court, this definition was intended to supplement well-defined terms like "stock" and "note." In order to avoid sweeping into the definition of "investment contract" a vast number of joint ventures, partnerships, and other business relationships,[35] the courts confined "investment contract" to a "transaction or scheme" under which persons are led to expect profits "solely from the efforts of" others. *Howey*, 328 U.S. at 298-99. This limitation on the definition of investment contract—intended to confine the number of business relationships qualifying as securities under the acts—had no bearing whatsoever on whether instruments like "stock" were securities. Stock, bonds, notes, and debentures were well-defined instruments; there was no need to import into the definition of such instruments limitations on business relationships that might be investment contracts. Nor would there be any logic in doing so. While Ruefenacht's stock purchase may not have constituted an "investment contract"—a term of art—because of the degree of corporate control he exercised, it certainly constituted an "investment" effectuated by means of the purchase of "stock." It is erroneous to conclude that one who does not enter into an "investment contract" is *ipso facto* not an "investor." It is doubly erroneous to reason further that such an individual is therefore unprotected by the federal securities laws even

"subsidiary" purpose. Moreover, this interpretation opens a new avenue of inquiry into gradations of the purchaser's intent; we doubt that lenghty pretrial discovery and hearings on such subtleties as whether the purchaser's "main" or "subsidiary" intent was "investment" promotes the purposes of the Acts. Nor do we believe the inquiry a fruitful one: the purchaser obviously intends both to invest and to manage.

35. *See, e.g.*, Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir. 1984); *id.* at 112 (Seitz, C.J., concurring); *id.* at 114 (Becker, J., concurring) (partnership agreement did not constitute an investment contract under the terms of the agreement).

though the transaction is effectuated by the purchase of an instrument clearly bearing all the attributes of stock.

5. *Arbitrary distinctions*

An additional consequence of the sale-of-business doctrine is the welter of unusual distinctions it produces among economic transactions. The sale of all of a corporation's stock to a single buyer by a single seller, for example, is alleged not to constitute the sale of a security; but the same sale to a single buyer by several sellers, each of whom did not formerly exercise control, is alleged to be a securities transaction as to the sellers but not as to the buyer.[36] Similarly, a series of stock sales each insufficient to transfer control from a single seller to a singly buyer would presumably constitute the sale of securities; a final sale leaving the buyer with stock ownership greater than 51 percent (and therefore transferring control) may or may not constitute the sale of securities, depending on how the doctrine is applied;[37] and the very same transaction consummated in a single purchase, rather than as a series of step transactions, would presumably not constitute the sale of securities.

Such distinctions are essentially arbitrary. The possibility of fraud is neither greater nor less when the purchaser acquires 49 or 51 percent of a business. Nor is the

36. McGrath v. Zenith Radio Corp., 651 F.2d 458, 467-68 n.5 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981); *see* Seldin, *supra* note 2, 37 Bus. Law. at 679-81.

37. The final sale itself arguably would not constitute the sale of a security because it transferred control to the buyer. Similarly, all prior sales amy not constitute sales of securities if they were effectively part of a single step transaction. On the other hand, it is plausible that each of the sales would constitute the sale of securities because each comprised less than 50 percent of the business. We hesitate to speculate on the proper application of the doctrine in these circumstances.

purchaser's capacity to discover fraud greater in one circumstance or the other. The variable of "control" is largely irrelevant to the risk of and capacity to discover fraud. As the Court of Appeals for the Second Circuit has observed, more appropriate considerations might include whether the sale involves a close corporation and whether the transaction takes place over a public market or face to face. *Golden v. Garafalo*, 678 F.2d at 1146. But close corporations and face-to-face transactions have always been within the compass of the acts. *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 10, 12 (1971); *see Glick v. Compagna*, 613 F.2d 31, 35 (3d Cir. 1979).

Moreover, in focusing on terms like "stock," "bond," and "note" in the early part of the definition of security, Congress drew on well-known state-law definitions. *See* Part III A 2 *supra*. These terms had a consistency of meaning under state law that did not vary with who owned the instrument at any particular moment, and did not admit of asymmetries between buyer and seller. Rather, they focused on the essential attributes of the instrument: voting rights, redemption rights, the right to participate in dividends, the right to participate in assets upon dissolution, etc. *E.g.*, 8 Del. Code Ann. § 151 (1983); 11 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 5083-5085 (1971). Fluctuations in the identity of the instrument were foreign to the notion of stock. The chameleon-like quality of stock under the sale-of-business doctrine is wholly arbitrary with respect to the state-law definitions that are the source of the terms in the 1933 and 1934 Acts.

Nor are we persuaded that economic affairs have magnified in complexity since the Seventy-Third Congress, thereby rendering these distinctions any less arbitrary. Of course, affairs of commerce are more sophisticated now than fifty years earlier; but the transaction at issue

here is not one that the appellees seek to steer clear of the securities laws because of its peculiar sophistication, and they do not argue that the transaction was unknown in earlier days. This is the simple purchase of 50 percent of a business by means of stock, a transaction as old as the concept of stock itself and certainly known to the drafters of the 1933 and 1934 Acts. If the increased sophistication of today's markets now renders appropriate a variety of distinctions that would have been rejected by the Seventy-Third Congress—an argument whose truth is hardly self-evident—we trust that Congress will amend the Acts accordingly.

6. *Adequacy of state-law protection*

Finally, it is urged that under the sale-of-business doctrine, the purchaser or seller of a business is not without a remedy for fraud; any remedy would simply lie in a common-law fraud action.[38] We do not believe that the prospect of common-law remedies changes the analysis. The premise that common-law remedies are necessarily adequate in the sale-of-business context is flawed. The defendant, for example, may prove to be insolvent, prompting the plaintiff to seek out solvent defendants among those parties who may be sued by virtue of the absence of privity requirements under federal law.[39] Congress, moreover, did not confine the protection of federal law to instances in which no adequate common-law remedy could be had. The Acts, for example, confer additional benefits on parties victimized by fraud, including the absence of express defenses and certain procedural advantages.[40] In view of the Supreme Court's

38. *See* Thompson, *supra* note 2, 57 N.Y.U. L. Rev. at 241-43.

39. *Cf.* Sonnehschein, *supra* note 15, 35 Bus. Law. at 1578.

40. *See generally* 1 L. Loss, *supra* note 28, at 22; 3 *id.* at 1430-34; Note, *Sale-of-Business Doctrine*, *supra* note 2, 83 Colum. L.

frequent emphasis on the remedial character of the securities Acts,[41] we do not take these proposed limitations on remedies lightly.

In summary, we do not believe that the policies underlying the Acts support the sale-of-business doctrine. To the contrary, the doctrine significantly undermines congressional policies, enhances uncertainty, and increases the likelihood of litigation. We turn now to whether recent Supreme Court authority requires a different conclusion.

B. *Recent Supreme Court Authority*

In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), the Supreme Court held that "stock" held by a tenant in a cooperative apartment building is not a security under the federal Acts. The Court's analysis of the term "stock" admonished us to attend to substance over form:

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply because the statutory definition of a security includes the words "any . . . stock." Rather we adhere to the basic principle that has guided all of the Court's decisions in this area:
>
> "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).
>
> See also *Howey, supra*, at 298.

Rev. at 1739 n.12, 1742; Note, *Commercial Paper, supra* note 15, 39 U. Chi. L. Rev. at 401 & n.264.

41. *See* Herman & MacLean v. Huddleston, ______ U.S. ______, 103 S. Ct. 683, 689-90 (1983) (availability of express remedy under § 11 of 1933 Act does not preclude action under § 10b of 1934 Act); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); *see* Lino v. City Investing Co., 487 F.2d 689, 692 (3d Cir. 1973).

421 U.S. at 848 (footnote omitted). The instruments held by the tenants, the Court concluded, lacked the attributes commonly associated with stock: the right to participate in dividends, negotiability, capacity to serve as collateral, voting rights in proportion to the number of shares owned, and appreciation in value. Consequently, the Court concluded, as a matter of economic reality the shares in issue were not "stock" within the meanings of the Acts. *Id.* at 851. As we noted earlier, the Supreme Court acknowledged that occasions may arise when the use of a particular name would lead a purchaser justifiably to assume that the federal securities laws apply, adding that "[t]his would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument." *Id.* at 850-51.

The Court then addressed whether the tenants' shares constituted an "investment contract" under the *Howey* test, concluding that they did not. *Id.* at 851-58. In the course of its investment contract analysis, the Court observed:

> In considering these [investment contract] claims we again must examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties. We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security.'" In either case, the basic test for distinguishing the transaction from other commercial dealings is

"whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301.

This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

421 U.S. at 851-52 (footnote omitted).

The defendants now maintain that the foregoing passages direct that the *Howey* test is to be applied to all of the defined terms in the Act, including the definition of stock. We do not agree. In its discussion of stock, the Court's admonition to attend to economic reality simply instructed that the label "stock" is not dispositive if the instrument lacks the traditional elements associated with stock ownership. The Court's analysis was clearly not intended to, and did not, apply the *Howey* test to stock. Nor did the Court direct that an economic reality test be applied to stock other than to determine whether, as a matter of economic reality, the instrument was in fact "stock" as that term has historically been understood. The label of the instrument may be pierced in order to determine whether it indeed bears the indicia of stock ownership. In this case the district court has done so, holding that the "stock which Ruefenacht received contains all the attributes mentioned by the *Forman* Court as indicating that the transaction did involve a security." App. at 220.

In the second portion of the *Forman* Court's analysis—addressing the definition of "investment contract"—the Court's reference to economic reality prefaced the

application of the *Howey* test. That analysis was entirely proper: the *Howey* test has for some 40 years been the appropriate metric for gauging whether, as a matter of economic reality, a business relationship constitutes an "investment contract." In no sense was the Court instructing that the *Howey* test also be applied to stock. Had the Court intended that result, of course, it would have done so. Nor was the Court holding that the same economic reality test applies to the definitions of "stock" and "investment contract." To the contrary, in assessing the economic reality of a stock transaction, we pierce the label and look to the underlying attributes of the instrument. In evaluating an investment contract, we apply the *Howey* test. Thus, *Forman* undermines rather than supports the defendants' position.

Subsequent Supreme Court authority is also unavailing. In *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1981), the Court held that a noncontributory, compulsory pension plan was not an investment contract. In part the Court reasoned that ERISA supplanted any necessity for coverage by the securities Acts. 439 U.S. at 569-70. The Court expanded on this theme in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), holding that a certificate of deposit insured by the FDIC did not constitute a security. Again the Court reasoned that the FDIC supplanted any necessity for coverage under the securities laws. 455 U.S. at 558. No such regulatory schemes apply in the sale-of-business context. Nor does the language in those opinions speak in favor of applying the investment-contract test to stock. Indeed, the Court's analysis in *Weaver* paralleled that of *Forman*: the Court first ascertained that a certificate of deposit is not a "note" or "withdrawable capital share," and only then turned to whether the separate agreement was an "investment contract" under the *Howey* test. 455 U.S. at 556-60. *Weaver* therefore reinforces our interpretation of *Forman*.

VI. Conclusion

We reject the sale-of-business doctrine as applied to sales of stock. The structure and history of the Acts—particularly Congress' express treatment of short-term notes and its conferral of exemption power on the SEC—counsel against such application. In addition, the doctrine is inconsistent with several policies underlying the Acts: it exacerbates uncertainty; undermines a congressional policy protecting certain instruments in order to reduce transaction costs and facilitate commerce; denies protection to investors simply because those persons are also "entrepreneurs"; deprives purchasers and sellers of part of the value of the bargain; and introduces arbitrary distinctions in the application of the definition of "security." Moreover, the doctrine derives from a misreading of *United Housing Foundation, Inc. v. Forman, supra. Forman* instructed that we attend to economic reality, in this case whether, as a matter of economic reality, the instrument has the attributes commonly associated with stock; *Forman* did not direct the application of the *Howey* test to stock. Finally, the doctrine originated as a limitation on the breadth of the word "note." While the *Howey* standard might have been an imperfect expedient in the note area—a subject on which we express no opinion—a similar limitation on stock is unnecessary. Stock is a well-defined term, is not issued by consumers, and is not employed by business to finance current operational costs.

Thus, we hold that the sale of all or part of a business effectuated by the transfer of stock bearing the traditional incidents of stock ownership is the sale of a "security" under the 1933 and 1934 Acts. The judgment of the district court will be reversed and the case remanded for further proceedings consistent with this opinion.

HUNTER, *Circuit Judge*, Concurring:

1. I concur in the majority's conclusion that plaintiff Max A. Ruefenacht ("Ruefenacht") purchased "securities" within the meaning of the Securities act and Securities Exchange Act when he purchased fifty percent of the shares of Continental Import & Export, Inc. ("Continental") in the form of instruments bearing the name and all the traditional attributes of stock. I note, however, that this court, in *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973), accorded the "context clause" of the federal securities acts a broader meaning than does the majority in this case. *Compare id.* at 694-95, *with* the majority opinion *supra*, typescript at 30-35.

2. Following *Lino*, I reach the same conclusion as the majority regarding the particular transaction at issue here. The court below found that Ruefenacht acquired no more than joint control over Continental, that Ruefenacht and Birkle exercised absolute veto power over each other in all important business matters, and that Ruefenacht continued to be a full-time employee of Autobern Trading Co., Inc. "The commercial context of this case," *see Lino*, 487 F.2d at 685, persuades me to conclude that the district court erred in dismissing Ruefenacht's claims for lack of federal jurisdiction under the securities acts. Accordingly, I join the majority in ordering a remand.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

CIVIL ACTION NO. 80-1097

MAX A. RUEFENAUCHT,
Plaintiff,
CHRISTOPHER J. O'HALLORAN,
JOACHIM K. BIRKLE and
CONTINENTAL IMPORT & EXPORT INC.,
Defendants,
and

CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,
vs.

W. GEORGE GOULD,
Third-Party Defendant.

OPINION AND JUDGMENT OF JUDGE SAROKIN

Newark, New Jersey
April 15, 1983

BEFORE:

HON. H. LEE SAROKIN, U.S.D.J.

(2) THE COURT: This matter comes before the court on a renewal of a summary judgment motion made by defendant W. George Gould. The facts of the case are summarized in this court's previous opinion on this motion; *Ruefenacht v. O'Halloran*, No. 80-4097 (D.N.J. April 21, 1982). Defendant Gould then moved for summary judgment dismissing the complaint for lack of federal jurisdiction.[1] Federal jurisdiction is based upon the federal securities laws. Defendant asserts that the transactions that are the basis of this suit did not involve "securities" as defined in the federal securities laws. Defendant moves to dismiss the federal claims for lack of jurisdiction and to dismiss the pendent state law claims as a matter of discretion.

In its previous opinion the court discussed a controversial point of law that has divided the federal courts of appeal. Briefly stated, the question is whether a transaction involving ordinary stock is necessarily a security transaction under the federal laws. The definitions of "security" in the federal statutes literally include "stock", but they also contain the words, "unless the context otherwise requires." 15 U.S.C. Section 77b; 15 U.S.C. Section 78c(a)(10). The Supreme Court and lower courts have applied an "economic reality" test[2] to determine whether transactions involve "securities" within the meaning (3) of the federal statutes,[3] but the Supreme Court has never applied this test to a transaction involving ordinary stock. Several circuit courts of appeal have

1. The other defendants in the case joined in the motion.

2. "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *S.E.C. v. Howey Co.*, 328 U.S. 293, 301(1946).

3. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837(1975); *S.E.C. v. Howey Co.*, 328 U.S. 293(1946); *Marine Bank v. Weaver*, ______U.S. ______, 102 S.Ct. 1220(1982).

applied this test to ordinary stock transactions. *Frederiksen v. Poloway*, 637 F.2d 1147(7th Cir.), *cert. denied*, 451 U.S. 1017(1981); *Sutter v. Groen*, 687 F.2d 197(7th Cir.1982); *King v. Winkler*, 673 F.2d 342(11the Cir. 1982); Chandler v. Hew, Inc. 691 F.2d 443 (10th Cir. 1977). Two circuit courts of appeal have refused to apply the "economic reality" test to transactions involving ordinary stock, concluding that these transactions are literally within the definitions of "security". *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202(4th Cir.1979), *cert. denied*, 444 U.S. 868(1979), *Golden v. Garofalo*, 678 F.2d 1139(2d Cir. 1982); *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227(2d Cir. 1982). The Third Circuit Court of Appeals has not yet ruled on this precise question.[4]

The court, in its previous opinion, determined that the "economic reality" test should be applied to transactions involving conventional stock to determine if they are entitled to the protection of the federal securities laws. The court characterized the crucial issue as "the amount of control" that plaintiff gained over the business whose stock was purchased (Continental Import & Export, Inc.). Slip. op. at 9. The court referred the matter to the Magistrate for a (4) hearing, and denied the motion for

4. The court in *Golden* cited *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979) as support for its position, at 678 F.2d 1142n.4. In *Glick* the court discussed the merits of regulating close corporations. 613 F.2d at 35n.3. This court has reviewed that decision and concludes that the court of appeals did not determine the precise question presented here. *Goodman v. DeAzoulay*, 554 F.Supp. 1029, 1034(E.D.Pa.1983). Several other district courts in this circuit have applied the economic reality test to transactions involving stock since *Glick*. *Anchor-Darling Industries, Inc. v. Suozzo*, 510 F.Supp. 659(E.D.Pa.1981); *Somogyi v. Butler*, 518 F.Supp. 970(D.N.J.1981); *Pallastrine v. Blimpie Industries, Ltd.*, No. 79-3328(E.D.Pa. Dec. 9, 1981).

summary judgment without prejudice to the right to renew upon completion of the hearing.

The court has received a Report and Recommendation from the Magistrate with detailed findings about the extent of control to be exercised by Mr. Ruefenacht in the business of Continental. Based on these findings, defendant Gould has renewed his motion for summary judgment.

The court has received objections to the Report and Recommendation from David Bernstein, a third-party defendant. Mr. Bernstein objects to the finding that Ruefenacht's "company is one of the third-party defendants, Autobern Trading Co., Inc., *in which Ruefenacht is associated with another third-party defendant, David Bernstein*" (emphasis added). Mr. Bernstein asserts that he was no longer associated with Mr. Ruefenacht or Autobern Trading Co., Inc., except as a shareholder in redemption, at the time of the transactions involved in this case. In addition, Mr. Bernstein objects to the findings that he was a continuing business partner in Autobern, and that he was to be paid five hundred dollars per week to handle the books and records of Continental. The court concludes that these findings are not necessary to a determination of the jurisdictional issue before it. Having received no opposition to their deletion (5) from any other party, the Court will adopt the Report and Recommendation without these findings as to Mr. Bernstein.

The conclusion of the Magistrate regarding the extent of control to be exercised by Mr. Reufenacht is as follows.

> Based upon the foregoing findings of fact it is concluded that Ruefenacht intended to purchase a 50% ownership of the shares of stock of Continental and to exercise all that control to which a 50% owner is

entitled. It has not been shown that there was any possible way that Ruefenacht could have exerted more control. His actions were at all times subject to the absolute veto of his partner, Mr. Birkle. The actions of the parties are consistent with equality of control and joint participation in the business of the corporation is clearly demonstrated by the evidence presented. There is no evidence to the contrary.

At oral argument on this renewed motion counsel for plaintiff once again urged the court to adopt the position that the "economic reality" test does not apply to transactions involving ordinary stock. The court has considered the arguments of counsel and the legal developments that have occurred since its original decision and concludes that its previous decision to the contrary should remain. The "economic reality" test should be applied to transactions (6) involving ordinary stock to determine whether they involve securities within the meaning of the federal securities acts.

In applying this test to the facts of this case the crucial question is whether the profits were to come "solely from the efforts of others." The other parts of the test are satisfied here, for the transaction involved investment in a common enterprise with an expectation of profits. The findings of the Magistrate indicate that Mr. Ruefenacht intended to exercise joint control of the business with Mr. Birkle; there would be "equality of control." Based on these findings the court concludes that the profits of the enterprise would not be derived "solely" or substantially from the efforts of others. Therefore, the transaction does not involve "securities" within the meaning of the federal securities acts.

The key to the application of the "economic reality" test to this case is that plaintiff was an active investor who intended to participate significantly in the management of the business. He was not a passive investor who relied on others to manage the business. "Not all sales transactions which involve 'stock' are necessarily covered by the securities laws. Rather, the test for coverage, in general is whether the purchaser is placing money in the hands of another who will control the funds and the business (7) decisions." *Frederiksen*, 637 F.2d at 1148. The court in *Sutter v. Groen*, 687 F.2d 197(7th Cir. 1982), characterized this distinction as one between investors, who "rent capital to those who want to manage", and entrepeneurs, who "buy assets to manage." *Id.* at 202. Plaintiff here was acting as an entrepeneur, with an intent to jointly manage the business, rather than as a passive investor, who rented his capital to others who managed the business.

Although many of the cases relied upon by defendant involve a sale of virtually one hundred percent of a corporation's securities and assumption of complete control of the business,[5] the amount of the stock purchased is not the determining factor. The more important factor is how much control the plaintiff intended to exercise over his investment. "It is apparent that the approach used here is not a function of numbers. A sale of less than 100% of the stock might not be covered by the Acts. A sale of 100% of the stock can be covered by the Acts." *King*, 673 F.2d at 346. In *Goodman*, 554 F.Supp. 1029, the court found that the purchaser of one-third of the stock of a corporation did not purchase "securities" within the meaning of the federal securities acts. The evidence indicated that the purchaser had "active control of her investment." *Id.* at 1035. The Seventh Circuit Court of Appeals has created a rebuttable presumption

5. *Frederiksen v. Poloway*, supra; *King v. Winkler*, supra; *Chandler v. Kew, Inc.*, supra; *Anchor-Darling Industries, Inc. v. Suozzo*, supra; *Somogyi v. Butler*, supra.

(8) to be used in cases where a large block of stock, but not 100%, has been purchased. *Sutter v. Groen*, 687 F.2d at 203. If the purchaser acquires more than fifty percent of the common stock of the corporation "his purpose in purchasing the stock will be presumed to have been entrepeneurship rather than investment." *Id.*[6] In *Pallastrone v. Blimpie Industries, Ltd.*, No. 79-3328(E.D.Pa. Dec. 9, 1981), the court found that purchasers of fifty percent of a company's stock had not purchased "securities." The court found that the "plaintiffs entered into the agreement with Figueroa for the purpose of purchasing a one-half interest in a business which they intended to operate and manage in conjunction with the defendant Figueroa . . ." Slip op. at 7.

The trend of the law is to apply the "economic reality" test to purchases of less than all of the company's stock to determine whether the purchaser would actively manage his investment. Because Mr. Reufenacht intended to jointly manage Continental with Mr. Birkle, he did not purchase "securities" as defined in the federal acts. Therefore, there is no jurisdiction to support the federal securities claims in the complaint. These claims are dismissed for lack of jurisdiction. There is no diversity of citizenship among the parties to support the pendent state law claims independently of the asserted basis for federal (9) jurisdiction. The court, in its discretion, will dismiss these claims as well. *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966).

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6. The court specifically did not consider the application of these principles to a purchase of fifty percent or less of a company's stock. *Id.*

UNITED STATES DISTRICT COURT
For the District of New Jersey

Hon. H. Lee Sarokin

Civil Action No. 80-4097

MAX A. RUEFENACHT,
Plaintiff,
v.

CHRISTOPHER J. O'HALLORAN,
JOACHIM K. BIRKLE,
CONTINENTAL IMPORT & EXPORT, INC.,
and W. GEORGE GOULD,
Defendants,
and

W. GEORGE GOULD,
Third-Party Plaintiff,
v.

DAVID BERNSTEIN, AUTOBERN TRADING
CO., INC., ERNEST STOECKLIN,
LENZENHOF GMBH,
Third-Party Defendants.

ORDER GRANTING SUMMARY JUDGMENT DISMISSING PLAINTIFF'S COMPLAINT

This matter being opened to the Court by Hannoch, Weisman, Stern, Besser, Berkowitz & Kinney, P.A., attorneys for defendant, W. George Gould, for an entry of

an Order for summary judgment dismissing plaintiff's complaint; and the Court having considered the parties' papers, pleadings, briefs and affidavits, and for good cause shown;

IT IS on this 16 day of May, 1983,

ORDERED that plaintiff Max A. Ruefenacht's complaint be and hereby is dismissed with prejudice.

/s/ H. Lee Sarokin
H. LEE SAROKIN, U.S.D.J.

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

HON. H. LEE SAROKIN

MAX A. RUEFENACHT,
Plaintiff,

CHRISTOPHER J. O'HALLORAN, et al.,
Defendants,

and

CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,

vs.

W. GEORGE GOULD,
Third-Party Defendant.

CIVIL ACTION NO. 80-1097

AMENDED ORDER GRANTING SUMMARY JUDGMENT DISMISSING PLAINTIFF'S COMPLAINT

COHN & LIFLAND, ESQS.
Attorneys for Plaintiff
Park 80 Plaza West One
Saddle Brook, N.J. 07662-5865

Heard: May 12, 1983

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

HON. H. LEE SAROKIN

CIVIL ACTION NO. 80-4097

MAX A. RUEFENACHT,
Plaintiff,

CHRISTOPHER J. O'HALLORAN, et al.,
Defendants,

and

CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,

vs.

W. GEORGE GOULD,
Third-Party Defendant.

AMENDED ORDER GRANTING SUMMARY JUDGMENT DISMISSING PLAINTIFF'S COMPLAINT

This matter being opened to the Court by HANNOCH, WEISMAN, STERN, BESSER, BERKOWITZ & KINNEY, P.C., attorneys for third-party defendant, W. George Gould, for entry of an Order for summary judgment dismissing plaintiff's complaint for lack of subject matter jurisdiction and all defendants not in default having joined therein; and the Court having considered the parties' papers, pleadings, briefs and affidavits, and for good cause shown;

It is on this 27 day of June, 1983;

ORDERED, that judgment be entered in favor of all defendants and against the plaintiff dismissing this action for lack of subject matter jurisdiction.

/s/ H. Lee Sarokin
H. LEE SAROKIN, U.S.D.J.

APPENDIX C

UNITED STATES CODE
TITLE 15

§ 77l. Civil liabilities arising in connection with prospectuses and communications

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

May 27, 1933, c. 38, Title I, § 12, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 9, 68 Stat. # 686.

APPENDIX D

UNITED STATES CODE
TITLE 15

§ 77q. Fraudulent interstate transactions

Use of interstate commerce for purpose of fraud or deceit

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce of by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Use of interstate commerce for purpose of offering for sale

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such

security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

Exemption of section 77c not applicable to this section

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

May 27, 1933, c. 38, Title I, § 17, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 10, 68 Stat. 686.

APPENDIX E

UNITED STATES CODE
TITLE 15

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

June 6, 1934, c. 404, Title I, § 10, 48 Stat. 891.

APPENDIX F

CODE OF FEDERAL REGULATIONS
12 CFR

§ 240.10b-5. Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.